PROTECTION OF A MORTGAGEE'S INTEREST IN REAL PROPERTY BY INSURANCE

The mortgagee is a more or less favored person in the eyes of the law under all forms of protection. Without exerting himself beyond inserting a stipulation in the mortgage contract that the mortgagor-owner should maintain insurance on the pledged property, he has been held to have an equitable lien on the proceeds of insurance in the event of loss.[1] In Maine, Massachusetts, Mississippi, and North Carolina his legal right to the proceeds of the insurance under certain conditions is reinforced by statutes giving him a lien on any and all indemnity for fire loss which may become due the mortgagor.[2] Such liens upon the latter's property could not satisfactorily compare, however, with a right to collect from large and almost universally solvent insurance companies with millions of dollars of assets; and mortgagees therefore preferred an interest in the insurance contract covering the mortgaged property, which interest may now be secured in various ways.

While under any method the mortgagee has some protection, its extent is not equal under all circumstances or in all jurisdictions. His status is subject to interpretation by the intermediate courts and courts of last resort of forty-eight states, not to mention the federal courts, and it is necessary to examine his rights according to the various principles promulgated.

1. *A mortgagee's policy covering his own interest.*—Since a mortgagee's security for a debt is impaired by fire destroying or damaging the pledged property, he undoubtedly has an insurable interest in the same and the right to insure it in his own interest.[3] In fact the mortgagee has been held to be entitled to indemnity even though

[1] G. A. Clement, *Fire Insurance as a Valid Contract*, pp. 41, 42; W. N. Bament, *The Mortgagee Clause*, an address before the Insurance Institute of Hartford, January, 1912, p. 5; *Wheeler* v. *Ins. Co.*, 101 U.S. 439; *Nichols* v. *Baxter*, 5 R.I. 491; *Aetna Ins. Co.* v. *Thompson*, 68 N.H. 20; *Chipman* v. *Carroll*, 53 Kan. 163; *Swearingen* v. *Hartford Ins. Co.*, 52 S.C. 309.

[2] Bament, *loc. cit.*, p. 5.

[3] R. W. Cooley, *Briefs on Insurance Law*, pp. 184, 185.

sufficient property remains uninjured as security for the debt.[1] In a policy issued to the mortgagee the mortgagor has no rights. The latter, since he also possesses an insurable interest, may nevertheless obtain a policy on the same property if he deems it desirable. A policy in the mortgagee's name conveys to the mortgagor no rights unless taken on his account or provided he pays the premiums; under these latter circumstances the indemnity collected by the mortgagee must be applied to reduce the debt.[2] The maximum indemnity due the mortgagee by the insurance company is not denoted by the value of either the mortgage or the property but by the amount of the debt.[3] The separate insurance of the interests of mortgagor and mortgagee is not particularly desirable from the standpoint of the company, inasmuch as such separation increases the difficulty of supervision, the moral hazard, and the danger of non-concurrent policies, and in one state results in direct financial loss to the insurer if permitted.

It is a principle of law, recognized in several relations, that an insurance company indemnifying a person for a loss of property is subrogated to all the rights—based on tort, contract or otherwise—which that person may possess against third parties and which may serve to diminish the loss of the insurer.[4] Upon payment of the indemnity to a mortgagee, therefore, the insuring company becomes possessed of the contractual right to collect from the mortgagor at the maturity of the mortgage a sum equal to the indemnity paid; in other words acquires a portion, at least, of the rights of the mortgagee.[5] To permit otherwise would be to grant the mortgagee double indemnity; he would collect the amount of the loss from the insurance company and in addition his claim on the mortgagor would be undiminished. The manner of settlement of a claim under a separate insurance of the mortgagee's interest, in which the mortgagor has no claim, may best be explained by a

[1] *Ibid.*, p. 780.

[2] *Waring* v. *Loder*, 53 N.Y. 581.

[3] George Richards, *Insurance Law*, p. 73.

[4] George Richards, "The Doctrine of Subrogation in Its Practical Application to Insurance," *Proceedings of the Insurance Society of New York*, November 26, 1912; Clement, *op. cit.*, pp. 359, 360.

[5] George Richards, *Insurance Law*, pp. 65, 394; Clement, *op. cit.*, p. 379.

simple illustration. O possesses a property valued at $10,000 which he has mortgaged to M for a loan of $9,000. M insures his interest in Company J for $9,000 and a loss of $8,000 subsequently occurs. The insurance company, J, pays M $8,000 and by subrogation acquires M's right to collect $8,000 from O at the expiration of the term of the mortgage, M retaining the right to collect at that time the remaining $1,000 due him. The insurance company, if it can ultimately collect the $8,000 from O, loses nothing. If O refuses to pay, foreclosure may be had, and if the property only brings, say, $8,500, the company loses $500, since it cannot legally in the collection of its claim against O prejudice in any way M's contractual right to $1,000.[1] An alternative settlement is the payment to M by J of $9,000 and the latter's acquisition by subrogation of a claim for $9,000.

The method of settlement described above is upheld by law in every jurisdiction except Massachusetts. There the company is not subrogated to the rights of the mortgagee;[2] in the foregoing illustration it would pay M $8,000 and receive nothing in return (except premiums paid), while M would still have a claim on O for $9,000. M thus practically receives a gift of $8,000 in addition to indemnity for his loss.

This method of protection for mortgagees has several advantages. In Massachusetts he receives double indemnity. In some instances, also, the mortgagee disapproves of the insurer selected by the mortgagor and for better protection obtains his own insurance. The disadvantages of such an insurance contract, however, are that the mortgagee is impressed with the expense of the premiums and the inconvenience of supervising the insurance. Other and more advantageous methods may be adopted.

2. *Assignment of the mortgagor's policy.*—A method of protection which merits little attention because of its disuse and disadvantages is the assignment of a mortgagor's policy to the mortgagee. In this case the policy assumes the nature of collateral security for the

[1] Richards, *loc. cit.*

[2] *International Trust Co.* v. *Boardman*, 149 Mass. 158; *King* v. *State Mutual Fire Ins. Co.*, 7 Cush. 1; *Allen* v. *Fire Ins. Co.*, 132 Mass. 480; Clement, *op. cit.*, note on p. 376; Cooley, *op. cit.*, p. 3915.

loan. The inefficacy of the method from the standpoint of the mortgagee lies, first, in the fact that he legally acquires by assignment only such rights as the mortgagor may have possessed at the time of assignment.[1] These rights will depend to some extent upon the nature of the assignment and the jurisdiction.[2] Violations or misrepresentations may have voided the policy and the mortgagee would then obtain a valueless piece of paper.[3] Secondly, the mortgagee has no legal status as a contracting party and consequently may not be entitled to notice of appraisal, to participate in negotiations after a loss, to redress if the mortgagor agrees to an inadequate settlement of the claim, etc.

3. *Indorsement of a "loss payable clause."*—A more extensively used method of obtaining insurance of a mortgagee's interest is the indorsement upon the mortgagor's policy of the so-called "loss payable clause," stipulating "loss, if any, payable to ———, as his interest may appear." From the standpoint of the companies this is desirable in some states because of the liability of the mortgagee for acts of the mortgagor,[4] and in general because of the elimination of separate insurance of interests in the same property and the reduction of moral hazard. But the desirability of such a method from the mortgagee's standpoint, it is to be strongly emphasized, entirely depends upon the state where it is used; two radically different interpretations of his rights are existent.

The first of these viewpoints is that such an indorsement renders the mortgagee an appointee and representative of the mortgagor-owner to receive the insurance money.[5] This is the position maintained in most of the states, including Alabama, New York, Wisconsin, Colorado, West Virginia, Indiana, Louisiana, New Jersey, Michigan, Tennessee, and Texas,[6] and it subjects the mortgagee to all the defenses available against the mortgagor.[7] Being only an appointee for a limited purpose an award is binding on him, although not a party to it,[8] and the election to rebuild or repair may be

[1] Clement, *op. cit.*, p. 37; S. Huebner, *Property Insurance*, p. 39.

[2] Cooley, *op. cit.*, p. 1530.

[3] Huebner, *loc. cit.*

[4] Cooley, *op. cit.*, p. 1521.

[5] Bament, *The Mortgagee Clause*, p. 5.

[6] Richards, *op. cit.*, p. 395.

[7] Cooley, *op. cit.*, p. 1227.

[8] *Collinsville Savings Soc.* v. *Boston Ins. Co.*, 77 Conn. 676; *Chandos* v. *American Fire Ins. Co.*, 84 Wis. 184.

exercised without notice to him.[1] He is not legally a party to the contract.[2] In these jurisdictions no method he could select affords him less protection than the "loss payable clause."

In marked contrast are the states which consider the indorsement of a "loss payable clause" the creation of an unconditional, independent contract between insurance company and mortgagee. In Illinois, Iowa, Mississippi, Nebraska, Missouri, and Washington the latter thus obtains without price, as one writer puts it, a contract which the owner cannot secure for any consideration.[3] He is not bound by the conditions of the policy, the acts of the mortgagor cannot be set up as a defense against him[4] and "if there are any rights which he does not possess it is either because he has not discovered them or has not enforced them."[5] When thus favored, this method is superior even to the protection of his interest by a standard mortgagee clause.

Since the settlement of claims is the same under the "loss payable" and "standard mortgagee" clauses this subject is treated under the latter.

4. *The "standard mortgagee clause."*—Of all the methods of protecting the mortgagee's interest the most prevalent, because of its general effectiveness, is the indorsement on the mortgagor's policy of a "standard mortgagee clause." One form of such clause is here given:

MORTGAGEE CLAUSE[6]

Loss or damage, if any, under this policy, shall be payable to. . . . . .as. . . . . mortgagee [or trustee], as interest may appear, and this insurance as to the interest of the Mortgagee [or trustee] only therein, shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property, nor by any foreclosure or other proceedings or notice of sale relating to the property, nor by any change in the title or ownership of the property, nor

1 *Heilmann* v. *Westchester Fire Ins. Co.*, 75 N.Y. 7.

2 Cooley, *op. cit.*, p. 790.

3 Bament, *loc. cit.*, p. 5.

4 Richards, *op. cit.*, p. 395, note.

5 Bament, *loc. cit.*

6 Another type of clause contains in addition a provision which states that the company shall not be liable for a greater proportion of any loss "than the sum hereby insured bears to the whole amount of insurance on said property, issued to or held by any party or parties having an insurable interest therein, whether as owner, mortgagee, or otherwise." This is known as the "mortgagee clause with full contribution."

by the occupation of the premises for purposes more hazardous than are permitted by this policy. PROVIDED, that in case the mortgagor or owner shall neglect to pay any premium due under this policy, the mortgagee [or trustee] shall, on demand, pay the same.

PROVIDED, also, that the mortgagee [or trustee] shall notify this company of any change of ownership or occupancy or increase of hazard which shall come to the knowledge of said mortgagee [or trustee] and, unless permitted by this policy, it shall be noted thereon and the mortgagee [or trustee] shall on demand pay the premium for such increased hazard for the term of the use thereof; otherwise this policy shall be null and void.

This company reserves the right to cancel this policy at any time as provided by its terms, but in such case this policy shall continue in force for the benefit only of the mortgagee [or trustee] for ten days after notice to the mortgagee [or trustee] of such cancellation and shall then cease, and this company shall have the right, on like notice, to cancel this agreement.

Whenever this company shall pay the mortgagee [or trustee] any sum for loss or damage under this policy and shall claim that, as to the mortgagor or owner, no liability therefor existed, this company shall, to the extent of such payment, be thereupon legally subrogated to all the rights of the party to whom such payment shall be made, under all securities held as collateral to the mortgage debt, or may at its option pay to the mortgagee [or trustee] the whole principal due or to grow due on the mortgage with interest, and shall thereupon receive a full assignment and transfer of the mortgage and of all such other securities; but no subrogation shall impair the right of the mortgagee [or trustee] to recover the full amount of ....claim.

Dated.................................

Attached to and forming part of Policy No................of the ———, of ———. *Agency at*.........................

.........................*Agent.*

Such favorable treatment as is outlined in the clause is accorded mortgagees by insurance companies because of the former's inability to control the acts of their debtors, their recognized right to protection, and their usual excellence as moral risks. By such a clause, it will furthermore be noticed, the right to subrogation is reiterated and acknowledged in the contract. An indorsement of this nature creates what is substantially an independent contract between the insurer and the mortgagee.[1] The word "independent" is thus qualified because two lines of decisions are existent on the liability of the mortgagee for his debtor's acts. In four states he has been declared

[1] Cooley, *op. cit.*, pp. 791, 1525.

entirely unaffected by such acts, whether committed prior or subsequent to the indorsement on the policy of the "mortgagee clause."[1] In four other states he has been held exempt from the consequences of acts occurring after its indorsement.[2] In one of these states the provisions of the standard policy after line 59 (which refer to conditions after a loss) were held to be inapplicable and not binding on the mortgagee.[3] He is privileged to submit proofs of loss,[4] to receive notice of appraisal[5] and to be exempt from the "rebuild or repair" provision.[6]

Illustrations will serve to define distinctly the nature of the settlement of claims under the "mortgagee clause." Assume that the value of O's property is $10,000, that the same is mortgaged to M for $4,000, and that O obtains a fire insurance policy for $4,000 from Company J on which a "standard mortgagee clause" is indorsed for M's protection. A loss of $3,000 occurs. Company J will pay to M, the mortgagee, $3,000. O, the owner, having an interest in the policy, however, is entitled to protection, and therefore is credited by M with $3,000 in liquidation of the debt, being thus reimbursed for the $3,000 damage to his property. An equivalent settlement would have been for J to pay M $4,000 then to take over M's claim against O of $4,000, and credit O with $3,000 toward payment of same.

A situation may exist, however, where O has violated the terms of the insurance contract and J disclaims all liability to him. In this contingency, when M receives $3,000 from the insurance company, instead of O receiving $3,000 toward the payment of the debt, the insurance company is subrogated to $3,000 of M's claim against O at the expiration of the mortgage. Thus O loses $3,000

[1] *Syndicate Ins. Co.* v. *Bohn*, 65 Fed. 165; *Mutual Fire Ins. Co.* v. *Alvord*, 61 Fed. 752; Cooley, *op. cit.*, p. 1527.

[2] *Glens Falls Ins. Co.* v. *Porter*, 44 Fla. 568; *Genesee, etc. Loan Assoc.* v. *U.S. Fire Ins. Co.*, 16 App. Div. (N.Y.) 587; *Baldwin* v. *German Ins. Co.*, 105 Iowa 379; *Hanover Fire Ins. Co.* v. *Bank*, 34 S.W. 333; Cooley, *loc. cit.*

[3] Bament, *op. cit.*, p. 12.

[4] *Ibid.*, p. 14.

[5] *Bergman* v. *Ins. Co.*, 92 Ky. 494; *Georgia Home Ins. Co.* v. *Stein*, 72 Miss. 943; *Hall* v. *Fire Assn.*, 64 N.H. 405; Clement, *op. cit.*, pp. 38, 39.

[6] *Hastings* v. *Ins. Co.*, 73 N.Y. 141; Clement, *loc. cit.*

because his policy was void, and the settlement is made as though O has never had an interest in the insurance.[1]

A more complicated settlement is involved where two mortgages are placed on the same property, although the governing principle is the same. Thus, let us assume that O possesses a property valued at $20,000, on which he borrows $10,000 on a first mortgage from A and $8,000 on a second mortgage from B. He secures a $10,000 policy in the Albion Insurance Company, on which he places a "standard mortgagee clause" for A's benefit and an $8,000 policy in the Brunswick Insurance Company with a "mortgagee clause" indorsed thereon for B's protection. A loss of $9,000 occurs. A provision of the standard policy stipulates that a company shall only be liable for the payment of a loss in the proportion its insurance bears to the total insurance. The Albion Company is responsible, therefore, for 5/9 of the loss or $5,000 and the Brunswick Company for 4/9 or $4,000. It would be useless and unfair, however, for the Albion Company to offer to pay A $5,000 when his security for the loan has been impaired to the extent of $9,000, and a similar difficulty arises in the case of B. The Albion and Brunswick companies therefore pay A and B, respectively, $9,000 and $8,000.[2] Since O has an interest in the insurance his debt, *as far as A is concerned*, is reduced by $9,000 and *as far as B is concerned* by $8,000. But O thereby receives $17,000 on a $9,000 loss, the Albion Company pays $9,000, although only liable for $5,000, and the Brunswick Company pays $8,000 where its liability is but $4,000. Accordingly the Albion Company is subrogated to A's claim against O to the extent of $4,000 and the Brunswick Company to B's claim against O to the extent of $4,000.[3] Since they thereby collect $8,000 from O at the maturity of the mortgage the latter receives only the $9,000 he was entitled to. The insurance companies in the collection of their claims must not prejudice the right of A to receive the $1,000 still due him.[4] Extensive depreciation

[1] Clement, *op. cit.*, p. 375.

[2] The Brunswick Company's payment is limited to $8,000 because (1) B's interest is only $8,000, and (2) the face of the policy is only $8,000.

[3] Richards, *Insurance Law*, p. 397.

[4] See copy of the "mortgagee clause," p. 948, *supra*.

of the value of the property may result, accordingly, to their detriment.

For the ordinary mortgagee the indorsement of the "mortgagee clause" affords the best protection in most states. Its advantages may be summarized as follows:

1. The prejudicial effect of the mortgagor's acts on the mortgagee's rights is considerably diminished in some states and entirely eliminated in others.

2. The mortgagee acquires legal rights as a party to the insurance contract.

3. The mortgagee is exempt in some states from certain provisions of the standard policy, such as the "repair and rebuild clause" and the provisions applying after a loss.

It has disadvantages, in comparison with other methods, in only a few jurisdictions. It is inferior to the "loss payable clause" in a limited number of states and is not as profitable as the separate insurance of the mortgagee's interest in Massachusetts.

A thorough discussion of the feature of contribution under the "mortgagee clause" is more appropriate to a paper on apportionment of loss, but a brief summary of three of the leading cases may be given. In *Hastings* v. *Westchester*[1] the facts laid before the New York court were that the owner had taken out a policy in his own name for $4,000 in the Lycoming Company and another with a "mortgagee clause" attached in the Westchester Company for $10,000, for the benefit of the mortgagee. The "mortgagee clause" was of the variety without contribution, a copy of which has been given. Both policies contained clauses, however, providing that the insurer should be liable only for that proportion of the loss which its insurance bore to the total insurance carried. A loss of $9,000 had occurred. The Lycoming Company paid the owner 4/14 of the loss, or $2,571.43, and the Westchester Company contended that its liability to the mortgagee was 10/14 of the loss or $6,428.57. The mortgagee claimed $9,000 from the Westchester Company and the court upheld his contention on the ground that the "mortgagee clause" constituted an independent contract and guaranteed him full protection of his interests. In view of such cases the companies

[1] 73 N.Y. 141.

inserted the contribution provision in the "mortgagee clause."[1] In the case of *Eddy* v. *London Assurance Corporation*[2] a mortgagor had protected his mortgagee with a policy having attached a "mortgage clause with full contribution," and subsequently, without the latter's knowledge, took out a second policy in his own interest. A loss occurred and the company which insured the mortgagee made practically the same contention as the Westchester Company in the preceding case, having the additional support of the contribution provision in the "mortgagee clause." The court held the latter provision to conflict with the provision in the same clause protecting the mortgagee against acts of the owner, gave the latter greater weight, and decided against the company. A decision in the federal courts, however, under exactly the same circumstances, was given to the opposite effect.[3]

5. *Special contracts.*—An even more satisfactory method of completely protecting the mortgagee is the formation of a special contract between insurer and mortgagee, embracing exceptional features for the latter's benefit. This, however, is chiefly used by trust companies and large lenders who place a great deal of insurance of this nature.

ROBERT RIEGEL

UNIVERSITY OF PENNSYLVANIA

[1] See footnote, p. 948, *supra.*

[2] 143 N.Y. 311.

[3] *Williams* v. *Hartford Fire Ins. Co.*, 63 Fed. 925. For a discussion of this subject see D. Ostrander, *Law of Fire Insurance;* Cooley, *op. cit.;* Bament, *op. cit.*